(25)

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 1024

In the Matter of

WAERN BUILDING CORPORATION,
Debtor.

ERNEST MORRILL,
Petitioner,

vs.

WAERN BUILDING CORPORATION,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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INDEX.

	PAGE
Petition	1
Statement of the Matter Involved	2
Summary of the Plan	6
The Effect of the Plan	6
Objections of Petitioner to the Plan	7
Jurisdiction to Review	8
Statute Involved	9
Questions Presented	9
Reasons Relied On	11
Prayer	14

TABLE OF CASES.

American United Mutual Life Ins. Co. v. City of Avon Park, 311 U. S. 138	10, 13
Carson v. Rebhan, 294 Ill. App. 180, 183, (1938); 13 N. E. (2d) 630, 631	3
Case v. Los Angeles Lumber Products Co., Ltd., 308 U. S. 106	2
Chicago City Bank & Trust Co. v. Bremer, 189 Ill. App. 258	4
Consolidated Rock Products Co. v. DuBois, 312 U. S. 510	2, 12
Fidelity Assurance Assn. v. Sims, 318 U. S. 608	10, 13
First National Bank v. Flershem, 290 U. S. 504	11
Group of Investors v. Milwaukee Railroad, 318 U. S. 523, 556	2, 12
Los Angeles Lumber Case, 308 U. S. 106	11

PAGE

TABLE OF CASES (Continued).

National Surety Co. v. Coriell, 289 U. S. 426 11

Northern Pacific Railway Co. v. Boyd, 228 U. S. 482, 508 2

Schmisseur v. Rebhan, 294 Ill. App. 172, 179; 13 N. E. (2nd) 627, 629 (1938) 3

Simon v. South End Cleaners Inc., 246 Ill. App. 14 (1927) 4

STATUTES AND TEXTBOOKS.

Bankruptcy Act:

Chapter X, Sec. 174 ..... 3, 9, 11, 13

Chapter X, Sec. 216 (10) 9, 10, 13

Chapter X, Sec. 221 ..... 3, 9, 11, 13

Ill. Revised Statutes (1943) State Bar Assn. Edition, Chap. 74, Sec. 4 (Interest) 3

Reeve, Illinois Law of Mortgages and Foreclosures (1932):

Vol. 1, P. 185 3

Vol. 1, P. 190 4

Vol. 2, P. 740 3

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Your Petitioner, Ernest Morrill, objecting bondholder, respectfully prays that a writ of *certiorari* issue to the Circuit Court of Appeals for the Seventh Circuit to review a judgment of that court entered on November 8, 1944, (petition for rehearing denied December 18, 1944) affirming an order of the United States District Court for the

Northern District of Illinois, Eastern Division, confirming a plan of reorganization. A certified transcript of the record in the case, including the proceedings in the Circuit Court of Appeals is furnished herewith in accordance with the rules of this Honorable Court.

Statement of the Matter Involved.

The court below held as fair and equitable a plan of reorganization under Chapter X of the Bankruptcy Act, which extended the first mortgage bonded indebtedness of $141,800.00 for six years and reduced the interest rate from 7% to 4½% (amounting to about $20,000.00 for the six-year extension) and at the same time permitted stockholder participation, in direct contravention of the full priority rule repeatedly announced by this court. In *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, for example, Mr. Justice Douglas, speaking for a unanimous court, said at Page 529:

> "If they (creditors) receive less than that full compensatory treatment, some of their property rights will be appropriated for the benefit of stockholders without compensation. This is not permissible." (Insert ours)*

Such a plan is not and cannot be "full compensatory treatment" and clearly amounts to an appropriation of property rights for the benefit of stockholders, without compensation.

In its opinion, the Circuit Court of Appeals avoided the obligation of the priority rule by holding that this petitioner did not object to the plan on this ground, either

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* To the same effect:

Northern Pacific Railway Co. v. *Boyd*, 228 U. S. 482, 508; *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106; *Group of Investors* v. *Milwaukee Railroad*, 318 U. S. 523, 556.

before the referee or the District Court, and, hence, could not raise the point for the first time on appeal. The Court of Appeals said (R. 233):

> "Appellant next argues that the plan violates the absolute priority rights of the bondholders because it does not provide for 7% interest. It is true that the bonds provide for an accelerated interest rate after maturity of 7% and that under the plan stockholders participate to the extent of their equity while the bondholders' interest rate is 4½%. The record shows that the appellant never objected to the plan on this ground at any time, either before the referee or the court. * * * Since he did not, the objection may not be raised for the first time in this court."

The Court below, in so holding, disregarded the plain provisions of Sec. 174 and Sec. 221 of Chapter X of the Bankruptcy Act, and failed to observe, moreover, the uniform decisions of this court holding that it is the affirmative duty of the District Court to examine the evidence to determine if the plan is fair and equitable as a matter of law. The trust indenture is in evidence and clearly shows a violation of the priority rights of the bondholders.

Almost every mortgage note or bond issued in the State of Illinois provides for interest at the rate of 7% after maturity of the debt, and the Courts of Illinois have uniformly held that such a rate of interest after maturity is just as much a contract provision for interest as the rate provided to be paid before maturity. *Schmisseur* v. *Rebhan*, 294 Ill. App. 172, 179; 13 N. E. (2nd) 627, 629 (1938); *Carson* v. *Rebhan*, 294 Ill. App. 180, 183 (1938); 13 N. E. (2d) 630, 631; Reeve, Illinois Law of Mortgages and Foreclosures (1932), Vol. 1, P. 185; also Vol. 2, P. 740. The 7% interest rate is expressly authorized by the Statute of the State of Illinois. See Chap. 74, Sec. 4 (Interest), Ill. Revised Statutes (1943) State Bar Association Edition. Under the Interest Act of Illinois (Chap. 74, Sec. 4) a

corporation may agree to pay interest without limit and beyond the rate specified for natural persons. *Simon* v. *South End Cleaners Inc.,* 246 Ill. App. 14 (1927).

The ruling of the court below approving a plan extinguishing the right to receive interest at the contract rate is in necessary conflict with the decisions of the Courts of Illinois, which have consistently recognized and enforced the right to receive the contractual increased interest rate after default. *Chicago City Bank & Trust Co.* v. *Bremer,* 189 Ill. App. 258; Reeves, Illinois Law of Mortgages and Foreclosures, Vol. 1, P. 190. Hence, the decision is in necessary conflict with an Illinois rule of property and presents a question of major importance in reorganization law which has not been, but should be, settled by this court. Several plans of reorganization have been confirmed in the Northern District of Illinois (before the decision of the Court of Appeals was handed down in the instant case), which recognized and enforced the right of bondholders to 7% interest after maturity in accordance with the express provision of the note and mortgage.

Waern Building Corporation, the Debtor, owns a four-story, furnished apartment building situated on the southwest side of Chicago, Illinois. The building and its furnishings constitute virtually its sole assets. In November 10, 1927, the Chicago City Bank and Trust Company underwrote a first mortgage bond issue for $165,000.00, the proceeds of which were used, or intended to be used, to construct the building in question. The bonds were sold by the bank to the general public (R. 84, 158). The trust indenture, securing the bond issue, designated the bank as trustee. Construction of the building was completed in May of 1928.

From 1927 to 1936, $8,000.00 of the bonds were retired. In 1936, the bond issue, then $157,000.00, was in default and the Debtor filed a voluntary petition for reorganiza-

tion under Section 77B (R. 158). On May 12, 1936, a plan of reorganization was confirmed which extended the bond issue to May 10, 1942. New bonds in the sum of $157,000.00 were exchanged for old. A new trust indenture was executed designating the same bank as indenture trustee. The new bonds, interest coupons, and trust indenture, all dated May 10, 1936, and all approved by the District Court, provided for interest at the rate of 4% from May 10, 1936, to May 10, 1939; 5% from May 10, 1939, to May 10, 1942, *and 7% after maturity.* The Debtor was required to deposit monthly up to May 10, 1939, the sum of $291.67, and thereafter annually, the sum of $3500.00, in a sinking fund to be used for the retirement of bonds at par or the lowest tendered price. If the Debtor's earnings were insufficient for the sinking fund deposits, it agreed to obtain the necessary funds from other sources (R. 66).

On May 10, 1942, the bond issue, then $141,800.00, was again in default. On May 12, 1942, Chicago City Bank and Trust Company, as indenture trustee, filed a foreclosure in the Circuit Court of Cook County, Illinois, to foreclose the trust deed. On the same day, the Debtor filed this, its second application for reorganization. Both the foreclosure and the reorganization petition alleged the inability of the Debtor to pay the balance of the bond issue, viz., $141,800.00. In its petition asking for a second reorganization, the Debtor scheduled its liabilities and capital structure as follows:

First Mortgage Bond Issue, principal due (Plus interest of 7% per annum after May 10, 1942)	$141,800.00
100 Shares Class A Preferred Stock, $100.00 par value	10,000.00
71 Shares Class B Preferred Stock, $100.00 par value	7,100.00
6680 Shares of Common Stock, no par value.	

After various hearings at which the proposed plan was modified by eliminating the common stockholders and the Class B stockholders, leaving outstanding only the bonds and new no par common stock, the new common stock to be distributed pro-rata to the holders of Class A Preferred Stock, the District Court confirmed the plan.

Summary of the Plan.

Briefly, the plan of reorganization contemplates the formation of a new corporation, the elimination of Series B and the common stock, the issuance of new common stock pro-rata to the Class A Preferred stockholders, the transfer of legal title to the building and furnishings to the new corporation, and the assumption by the new company of the bond issue and the trust indenture. The plan provides for a second extension of the bond issue, i. e., from May 10, 1942, to May 10, 1948, with interest at 4½% annually *and 7% after maturity.* The 4½% interest rate was fixed by the Debtor by taking the average interest rate which the Debtor paid to the bondholders from 1936 to 1942, the extension period under the 77B plan. The Debtor again commits itself to deposit annually, out of earnings or from other sources, the sum of $3500 in a sinking fund for the retirement of bonds at par or the lowest tendered price and to deposit all net rentals with the indenture trustee. Except for a straight payment of 4½% interest to bondholders and the advancement of the maturity date of the debt to May 10, 1948, the plan, as it concerns bondholders, is precisely the same plan as confirmed in 1936.

The Effect of the Plan.

a. For the second time in a federal reorganization proceeding, and within six years, it extends the time for the payment of the bond issue.

b. It reduces the rate of interest to bondholders from 7%, the rate fixed in the bonds and trust indenture as payable after maturity (May 10, 1942), to 4½%, and at the same time permits stockholder participation.

c. It maintains the Class A Preferred Stock in the position of full equity ownership and in full control of the new corporation unless default occurs, notwithstanding its interest in the equity is relatively small, if, indeed, there is an equity.

d. It again requires the Debtor to make an annual deposit of at least $3500.00 from its earnings or other sources in a sinking fund for the retirement of bonds. The Debtor has no "other sources" and its past earning record over 14 years demonstrates its incapacity to meet this requirement. Under the plan, in the event of default, foreclosure is the sole remedy.

Objections of Petitioner to the Plan.

For purposes of later discussion, it is necessary to point out here that petitioner, a bondholder, objected before the Referee and the District Court to the approval and confirmation of the plan on grounds that the plan was not fair and equitable, or feasible; that a similar plan confirmed under 77B failed; that there was no reasonable likelihood this plan could succeed and hence the seed of a third reorganization was being sown; that on the basis of its past record the Debtor would be unable to meet its annual sinking fund requirements of $3500.00; that from 1928 to 1936 only $8000.00 in bonds were retired; that from 1936 to 1942 only $15,200.00 in bonds were retired; that the property has depreciated and will depreciate more than the amount of bonds retired annually; that there is no reasonable likelihood that the Debtor will be able to retire or refund the bond issue in 1948; that a

favorable market presently exists for the property involved and it should be sold at an upset price to be fixed by the court pursuant to Section 216 of Chapter X of the Bankruptcy Act; that bondholders who desire payment of their bonds should now be paid; that in the event of a default under the plan bondholders should be permitted to sell or acquire the property without the expense and delay incidental to foreclosure; that the Debtor whose equity, if any, is relatively nominal, would continue to have complete control over the building; that no competent valuation data was available to the court or creditors at the time of the hearing on the plan for submission to the interested parties; that the court should have appointed an independent appraiser to appraise the property; that the indenture trustee has sponsored the plan because it has a personal interest in the compensation it receives for acting as trustee and in the deposits it secures for the bank; that the activities of the indenture trustee in the purchase and sale of the bonds in question and in the formation and dissolution of a bondholders protective committee and other transactions require full investigation by the court; that the indenture trustee occupies conflicting positions and should be removed; that in view of the public interest and the conduct of the indenture trustee, the Securities and Exchange Commission should be invited to participate in the proceeding.

Jurisdiction to Review.

The judgment of the Circuit Court of Appeals for the Seventh Circuit was entered November 8, 1944. Petition for rehearing was denied December 18, 1944. The jurisdiction of this court is invoked under Sec. 240 (a) of the Judicial Code, as amended by Act of February 13, 1925 (28 U.S.C.A. Sec. 347 (a)) and Sec. 24 (c) of the Bankruptcy Act, as amended in 1938 (11 U.S.C.A. 47).

Statute Involved.

The statute involved is Chapter X (Secs. 174 and 221) of the Bankruptcy Act, as amended (11 U.S.C.A. 47). Sec. 174 reads in part as follows:

> "* * * The judge shall enter an order approving the plan or plans * * * which are fair and equitable and feasible * * *."

The pertinent portion of Sec. 221 is:

> "The judge shall confirm a plan if satisfied that the plan is fair and equitable, and feasible * * *."

Under Section 216 (10) of Chap. X it is provided that a plan may provide for

> "the sale of all or any part of its property, either subject to or free from any lien, at not less than a fair upset price and the distribution of all or any assets, or the proceeds derived from the sale thereof, among those having an interest therein; * * *."

Questions Presented.

1. Where under an extension plan confirmed under 77B in 1936, it is provided in the bonds and trust indenture (approved by the District Court) that the bond issue shall be extended to May 10, 1942, and that bondholders shall be paid interest at the rate of 4½% from 1936 to 1939; 5% from 1939 to 1942, *and 7% after maturity* (May 10, 1942) and where the plan failed because the debtor could not pay the bond issue at its maturity, does a new plan filed in a new proceeding which again extends the bonds to May 10, 1948, reduces the rate of interest from 7% to 4½%, and at the same time permits stockholder participation, violate the *absolute priority rule* as announced by this Court in the *Los Angeles Lumber Case* and other cases?

2. Was the Circuit Court of Appeals correct in holding as a matter of law that notwithstanding a plan of reorganization violates the priority rights of creditors, neither the Circuit Court of Appeals nor the District Court is required to take cognizance of the violation unless specific objection is raised in the District Court?

3. Where a debtor corporation's sole asset is a furnished apartment building and its principal debt is the balance due on a first mortgage bond issue, does a plan of reorganization meet this court's test of feasibility when it proposes, for the second time in six years, to extend the bond issue in the face of its past earnings record extending over fourteen years, which indisputably discloses that it has never at any time been able to meet its sinking fund requirements of $3,500.00 annually for bond retirement, and where the record fails to show any reasonable probability that it will be able to pay or refund the balance of the indebtedness at the end of the second extended period?

4. Is the rule requiring full disclosure by a trustee as announced by this court in *American United Mutual Life Insurance Co.* v. *City of Avon Park*, 311 U. S. 138, violated by an indenture trustee, the underwriter of the bond issue, which fails to disclose (1) its personal interest in the plan; (2) how and when it acquired the bonds it owns; (3) how much was paid for the bonds it owns and from whom the bonds were purchased; (4) to what extent it has trafficked in the bonds; and (5) its activities in the formation and dissolution of a bondholders protective committee? The District Court and the Court of Appeals ignored this question.

5. Chapter X, Sec. 216 (10) of the Bankruptcy Act expressly authorizes a plan of reorganization providing for the sale of the debtor's property at an upset price. Does *Fidelity Assurance Association* v. *Sims*, 318 U. S. 608, prohibit the approval or confirmation of such a plan?

Reasons Relied On for Allowance of Writ.

1. The Court of Appeals ruled that notwithstanding the rate of 7% interest after maturity is fixed in the bonds and the trust indenture, a plan of reorganization may extend the maturity date of the debt, fix an interest rate lower than the contract rate, and at the same time permit stockholder participation. Almost every mortgage note and trust indenture in the State of Illinois provides for interest at 7% after the maturity of the debt. Courts of Illinois have uniformly upheld interest at 7% after maturity in suits on notes and foreclosures on mortgages. Are the rights of bondholders less because their bonds are extended in a reorganization proceeding? Plans of reorganization have been confirmed in the Northern District of Illinois (before the decision of the Court of Appeals was handed down in the instant case) which recognized the right of noteholders to 7% interest after maturity in accordance with the express provisions of the note and mortgage. The rule of law announced by the court below is in direct conflict with the Illinois law and presents a question of major importance in reorganization law which has not been, but should be, settled by this Court.

2. The Court of Appeals departed from the statutory mandate in Chapter X (Secs. 174 and 221) of the Bankruptcy Act and from the decisions of this Court in the *Los Angeles Lumber Case*, 308 U. S. 106; *First National Bank* v. *Flershem*, 290 U. S. 504, and *National Surety Co.* v. *Coriell*, 289 U. S. 426, in holding that a *specific* objection to a plan as violating the priority rule *must* be filed by a creditor in the District Court before it can be raised on appeal. Even a general objection to the plan as not "fair and equitable, or feasible" was not considered sufficient by the Court of Appeals. Under Secs. 174 and 221 of Chapter X and the applicable decisions of this Court, it is

the affirmative duty of the District Court, even if no objections are filed, to examine the proof to determine if the plan is fair and equitable, and feasible.

3. In holding that the contract interest rate of 7% after maturity, fixed by the bonds and trust indenture, may be reduced and at the same time stockholders allowed to participate in the plan, the opinion of the Court of Appeals departs from the principle announced by this Court in *Group of Investors* v. *Milwaukee Railroad, etc.*, 318 U. S. 523, and *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, viz., that accrued interest at the contract rate shall be treated the same as principal and shall be given the same priority as principal before stockholders may participate in the reorganization.

4. In declaring the plan feasible, the Court of Appeals disregarded the poor past earnings record of the building in question and relied almost entirely on current or war earnings, contrary to the rule stated by this Court in *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, and *Group of Investors* v. *Milwaukee Railroad, etc.*, 318 U. S. 523. The opinion disregards the only practical test of feasibility in a real estate reorganization, viz., on the basis of the past earnings record of the building, will the net income be sufficient in amount and stability to provide the regular payments of interest together with the periodic payments on the principal so that at maturity the remaining mortgage debt can be paid or readily refunded? In a real estate enterprise the chief asset has a limited economic life and funds are not set aside for replacement as in an industrial enterprise. This Court has never applied the test of feasibility to a plan involving a real estate enterprise.

5. The Court of Appeals failed to distinguish between a hearing on the question of whether or not a plan should be *approved for submission to creditors and stockholders,*

pursuant to Sec. 174 of Chapter X of the Bankruptcy Act, and a hearing on *confirmation* under Sec. 221. Before a plan may be approved for submission, there should be available to the court and the interested parties competent valuation data from disinterested sources relating to the debtor's property and its earning capacity so that the court and the interested parties may intelligently determine whether the plan is fair and equitable, and feasible. This information was not available at the time of the *hearing on this plan for submission to the interested parties.* The production of this information at the hearing on confirmation (after the plan had been submitted to the interested parties and the vote taken) does not cure the defect. The Court of Appeals made no comment on this objection. Failure to observe this procedural requirement of Chapter X may operate, as it did here, to the detriment of the bondholders. Without such valuation data the court was not in a position to exercise its "informed, independent judgment" and creditors could not intelligently vote on the plan.

6. The Court of Appeals and the District Court failed to follow the holding of this Court in *American United Mutual Life Insurance Company* v. *City of Avon Park,* 311 U. S. 138 in requiring the indenture trustee, the underwriter of the bond issue, to make a complete disclosure of its activities.

7. Chapter X, Section 216 (10) of the Bankruptcy Act expressly authorizes a plan providing for a sale of the debtor's property at an upset price. Pursuant to Section 167 (6) of Chap. X and in view of the favorable market we suggested to the Referee the sale of the building at an upset price. The Referee rejected the suggestion on the ground that "Chapter X contemplates reorganization rather than liquidation" (R. 104). Since *Fidelity Assurance Association* v. *Sims,* 318 U. S. 608, some doubt has

existed as to whether a plan may provide for the sale of the debtor's property at an upset price. Real estate enterprises have constituted and still constitute the bulk of reorganization proceedings in the Federal Courts. It is frequently desirable to sell the property under a plan. A decision by this Court on the question whether or not a plan may provide for a sale of all the debtor's assets at an upset price and removing the doubt created by the *Sims* case, is of prime importance in reorganization law.

PRAYER.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Court, directed to the United States Circuit Court of Appeals for the Seventh Judicial Circuit, commanding said court to certify and send to this Court on a day to be designated, a full and complete transcript of the record and of all proceedings of the said Circuit Court of Appeals had in this cause, to the end that this cause may be reviewed and determined by this Court; that the judgment of the Circuit Court of Appeals for the Seventh Judicial Circuit affirming the order of the District Court be reversed and remanded, and the petitioner be granted such other and further relief as may seem proper.

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